Testimony – House Financial Liabilities Reform Committee

My name is Phil Stoddard, and I am the Director of the Office of Retirement Services, an agency within the Department of Technology, Management and Budget. I am here today to give you an overview of the issue of stranded costs.

The Michigan Public School Employees Retirement System is a multi-employer cost-sharing plan. When and if unfunded accrued liabilities emerge in the system, they are funded by schools as a percentage of their active member payroll. Stranded costs in the broadest sense occur when there was a payer before and through whatever circumstance there is no longer a payer, and therefore the remaining payers have to pay more. There are natural stranded costs, and there are stranded costs that emerge because of deliberate action. An example of a natural stranded cost would be where the population of Michigan has declined, and so the student count and therefore employee count overall has declined. An example of deliberate stranded costs occurs when school employers intentionally reduce covered payroll, for example through retirement incentives offered by local schools and special contractual arrangements. School employers who do not intentionally reduce their covered payroll have this expense offloaded on them and thus bear a disproportionate share of pension unfunded accrued liability (UAL) and retiree health care costs (their own share plus).

To be clear, we do not oppose privatization provided there is an accurate apples-to-apples cost/benefit analysis done. The State has adopted a method of bidding contracts that take the fixed costs of the retirement system into account. Right now, some districts are not accounting for fixed retirement costs in their contract bids; this hurts not only the retirement system, but every other district in the system. Secondarily, the payroll methodology we have in place leaves the school district that does successfully privatize with no mechanism to continue to pay their share of their stranded costs.

The current active member base in MPSERS has declined by 32% since 2003. We had 327,000 active members in in 2003 and 223,769 in 2012. **As membership declines, the contribution rate automatically increases because the dollar amount needed to make the amortization payment on the unfunded accrued liability does not change.** During this same period, the active member payroll declined from $10.02 billion for the fiscal year ending September 30, 2003 to $9.56 billion for the year ending September 30, 2011.

Had payroll grown by 3.5% annually over the past decade (or remained stable), the FY 2014 employer contribution rate as a percentage of payroll would be approximately 7% of pay or more lower. Some employers have reduced the number of employees while other employers have not done so. As a result, employers whose active member populations have remained stable or increased are bearing a higher portion of the amortization of the UAL component of the contribution. A major portion of the UAL is associated with retirees, so privatization does not eliminate liabilities.

If you follow the natural flow of the money and realize that costs for privatization as well as all payroll are included in the Current Operating Expenditures (COE), you might look at that as being a more fixed base to assign the costs to. HB 4190, which has already been introduced and referred to this committee, covers this (although it needs review and amendments). COE appears to be a broader, more stable and consistent funding base than payroll, as long as it is consistently applied to all reporting units. Initially it will create winners and losers (proportionate to those districts that are currently stranding costs). This method allows districts to contract without stranding costs. Bethany Wicksall is going to provide more information regarding this method.